



## CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

June 1, 2006

### **H.R. 3043** **Zero Downpayment Pilot Program Act of 2005**

*As ordered reported by the House Committee on Financial Services on May 23, 2006*

#### **SUMMARY**

H.R. 3043 would authorize—through fiscal year 2010—a new loan guarantee program under the Federal Housing Administration (FHA) that would allow first-time home buyers to purchase a home without a down payment. Currently, FHA's single-family loan guarantee program requires home buyers to make a down payment of at least 3 percent of the sales price.

CBO estimates that implementing this legislation would cost \$65 million over the 2007-2010 period, assuming future appropriation actions consistent with the bill. FHA's loan guarantee programs are discretionary federal credit programs that require appropriation action each year to establish a dollar limitation on the value of loans that may be guaranteed and to provide a credit subsidy appropriation for those FHA programs estimated to have a positive subsidy rate.

Enacting this bill could affect direct spending and receipts because the bill would provide the Secretary of Housing and Urban Development (HUD) with the authority to establish penalties against borrowers who fail to meet certain requirements under the bill. CBO estimates that any increase in civil or criminal penalties would not be significant.

H.R. 3043 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act and would impose no costs on state, local, or tribal governments.

## ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 3043 is shown in the following table. The costs of this legislation fall within budget function 370 (mortgage and housing credit). For this estimate, we assume the bill will be enacted near the end of fiscal year 2006.

	By Fiscal Year, in Millions of Dollars					
	2006	2007	2008	2009	2010	2011
<b>SPENDING SUBJECT TO APPROPRIATION</b>						
FHA and GNMA Spending Under Current Law <sup>a</sup>						
Estimated Authorization Level	-1,013	-333	-327	-331	-344	-353
Estimated Outlays	-1,013	-333	-327	-331	-344	-353
Proposed Changes						
Net Subsidy Cost for Zero Down-Payment Loans						
Estimated Authorization Level	0	14	23	20	16	0
Estimated Outlays	0	14	23	20	16	0
GNMA Offsetting Collections						
Estimated Authorization Level	0	-2	-2	-2	-2	0
Estimated Outlays	0	-2	-2	-2	-2	0
Total Changes						
Estimated Authorization Level	0	12	21	18	14	0
Estimated Outlays	0	12	21	18	14	0
Total FHA and GNMA Spending Under H.R. 3043						
Estimated Authorization Level	-1,013	-321	-306	-313	-330	-353
Estimated Outlays	-1,013	-321	-306	-313	-330	-353

NOTE: GNMA = Government National Mortgage Association; MBS = Mortgage-Backed Securities.

- a. The figures for 2006 are CBO's current estimates of budget authority and outlays for these programs under the enacted appropriation levels for this year. The 2007-2011 levels are CBO's baseline estimates of the amount of offsetting collections generated by FHA's single-family program and GNMA's single-family MBS program.

## BASIS OF ESTIMATE

The budgetary impact of the zero down-payment loan program would depend on how many households would use this provision to help them become homeowners and the likelihood that such borrowers would default on their mortgages. CBO estimates that implementing

H.R. 3043 would cost FHA \$14 million in 2007 and \$73 million over the 2007-2010 period to pay for the estimated subsidy cost of the zero down-payment program. We also estimate that new federal loan guarantees made under the new program (about 60 percent of all zero down-payment loans) would be included in the Government National Mortgage Association's (GNMA's) Mortgage-Backed Securities (MBS) program, resulting in the collection of additional negative subsidy receipts of \$8 million over the 2007-2010 period. Thus, CBO estimates that the net federal cost of the new program would be \$65 million over the 2007-2010 period, including effects on both FHA and GNMA programs. There also would be a cost associated with the Government Accountability Office (GAO) studies that are required under this bill. However, CBO estimates that those costs would be less than \$500,000 each year. Each of these budgetary effects are discussed below.

### **Proposed Zero Down-Payment Mortgage Guarantee Program**

The new loan guarantees would be available to home buyers purchasing various types of one-to-three family residences, such as single-family homes and condominiums, through September 30, 2010. Borrowers who want to participate in this pilot program would be required to attend individual counseling sessions related to financial management skills for homeowners prior to applying for the loan. Under the bill, the number of zero down-payment loans insured by FHA each year could not exceed 10 percent of the total number of single-family FHA loan guarantees made during the preceding year, and no more than 50,000 loans could be insured over the life of the program. This legislation also would allow FHA to charge up-front and annual fees up to the levels set under current law (2.25 percent and 0.55 percent of the loan amount, respectively) for the existing single-family program.

### **Demand for the Zero Down-Payment Program**

According to FHA, mortgage banking associations, and industry experts, the number of private entities supporting down-payment assistance programs and zero down-payment programs in recent years has grown, indicating a growing demand for programs that help home buyers who cannot afford down payments. For example, the Nehemiah Corporation, which is the oldest and largest nonprofit provider of down-payment assistance in the country, provided assistance to over 5,500 home buyers in 1998 compared to 20,000 home buyers in 2005. Furthermore, the National Association of Realtors reports that 43 percent of all first-time homebuyers in 2005 financed their home purchases with a zero down-payment mortgage.

This bill would limit the loan volume for the zero down-payment program to no more than 10 percent of single-family loan guarantees made by FHA in the preceding year (i.e., 33,000

to 37,000 loans estimated per year) and to no more than 50,000 loans over the life of the pilot program. CBO expects that demand for a zero down-payment loan guarantee program would be strong and, based on information from FHA, expects that 50,000 loans with a face value of about \$6 billion to \$7 billion (known as the loan volume) could be guaranteed over the 2007-2010 period. CBO estimates that the number of loans guaranteed each year of the program would be roughly the same, though CBO expects that fewer loans would be guaranteed during the initial year of the pilot program, as FHA would need some time to make the administrative changes necessary to support the new program.

### **Choice Between Traditional FHA Guarantee and Zero Down-Payment Program**

According to FHA, about 70 percent of its borrowers are first time home buyers, and an increasing number of them are using some form of down-payment assistance (e.g., gifts from relatives or grants from nonprofit entities). On average, these borrowers represent about 40 percent of FHA's first-time home buyers making the minimum 3 percent down payment. CBO estimates that about 90,000 FHA borrowers who are first-time home buyers will use some form of down-payment assistance each year.

From the perspective of the FHA borrower, there would be both advantages and disadvantages to using the new zero down-payment program instead of the existing single-family program. On the one hand, under the new program the borrower would not need to seek gifts from relatives or use down-payment assistance programs, which can result in the borrower paying an increased amount for the home. On the other hand, the fees under the zero down-payment program would be higher than the regular FHA program, the borrower would have no equity in the home, and the borrower would be required to attend financial counseling, though, in some cases, the borrower may readily accept the potential benefits of meeting with a counselor and consider the assistance to be an advantage. CBO estimates that about 40 percent of the 50,000 borrowers expected to participate in the pilot program would have used the existing single-family program if the proposed zero down-payment program did not exist. We estimate that this shift of about 20,000 borrowers or \$3 billion worth of loan guarantees over the 2007-2010 period from the existing single-family program to the new zero down-payment program would reduce the subsidy cost of the FHA program, as discussed below.

## **Credit Risk Associated with the Zero Down-Payment Program**

Zero down-payment loans are viewed by private-sector lenders as having a higher risk of default than traditional mortgages with down payments according to several industry experts involved with the secondary-mortgage market, trade associations, and down-payment assistance programs. For private lenders, the borrower's loan-to-value (LTV) ratio indicates how much equity a borrower initially has in the home and serves as one of the predictors of the likelihood of default. On average, borrowers with less equity (that is, higher LTV ratios) have higher default rates than borrowers with more equity. Such borrowers are more vulnerable to adverse events, such as job loss and falling house prices. Under the proposed zero down-payment program, borrowers would become homeowners with zero or negative equity because borrowers could finance their up-front premiums and closing costs, resulting in LTV ratios of 103 percent or more.

To compensate for this risk of default, FHA has indicated that it would not change the credit standards (e.g., debt-to-income ratios and payment-to-income ratios) for zero-down payment borrowers. Instead, FHA would charge such borrowers higher loan-guarantee fees than those charged to borrowers under FHA's current single-family program. CBO assumes that FHA would charge zero-down payment borrowers the highest fees authorized under current law. That is, the up-front fees for the new program would be 2.25 percent of the loan value and annual fees would be 0.55 percent of the loan value. (In comparison, borrowers in the existing program pay an up-front premium of a 1.5 percent and annual premiums of 0.5 percent.)

## **Financial Counseling**

Based on information from industry experts and credit studies, CBO expects that the counseling required under this legislation could contribute to better loan performance and consequently fewer defaults. We estimate that the claims rate for the zero down-payment loans could be lowered by about 25 percent compared to the claims rate for loans receiving some type of down-payment assistance, resulting in a cumulative claim rate of about 20 percent for the zero down-payment loans. Despite these higher fees and the mandatory counseling, however, CBO expects that default costs could still exceed the value of the higher fees.

## **Program Suspension**

This bill would require FHA to suspend the zero down-payment program if more than 3.5 percent of the loans in the program are foreclosed in one year. CBO estimates that defaults for the new program would average about 1 to 2 percent each year and that the cumulative default rate over a 30-year period would be close to 20 percent. This restriction on the number of defaults could limit the number of loans FHA insures each year if the number of foreclosures is greater than we estimate. But other factors, such as changing consumer demand for the program due to higher interest rates, could also lead to a smaller loan volume in the program. The zero down-payment program would be considered a discretionary program that could be suspended by FHA at any time. For this estimate, CBO assumes that the necessary subsidies are provided each year through the appropriation process and that the subsidies are spent each year.

## **Subsidy Cost**

CBO estimates that implementing the zero down-payment program would result in a net cost of \$12 million in 2007 and \$65 million over the 2007-2010 period, reflecting changes to FMA and GNMA programs. The estimated loan subsidy costs—which are treated as discretionary spending—would be recorded in the budget each year when the subsidy appropriation is provided.

**FHA Costs.** Budget procedures for federal credit programs require that funds must be appropriated in advance to cover the subsidy cost of the loan guarantees, as estimated on a present value basis. CBO estimates that the new program would have a subsidy rate of about 1.85 percent, compared to our estimate of the 2007 subsidy rate of -0.37 percent for FHA's existing single-family program. This estimated subsidy rate assumes that FHA would charge the maximum fees allowable under current law (2.25 percent for the up-front fee and 0.55 percent for the annual fee) and that the cumulative claims rate for the program would be about 20 percent, or two times the claims rate for the average FHA loan. With a subsidy rate of 1.85 percent, CBO estimates that the zero down-payment program would cost \$125 million over the 2007-2010 period.

This estimated subsidy cost would be partially offset by some expected savings associated with borrowers shifting from the existing single-family program to the zero down-payment program. The borrowers that would shift to the new program would tend to have a greater risk of default than the average FHA loan. CBO estimates that the shift of these borrowers to the new program would leave the remaining portfolio of single-family loan guarantees in a better financial position with an overall slightly more negative subsidy rate. CBO estimates that the negative subsidy associated with the existing single-family program would decrease

by about 0.1 percent beginning in 2007, resulting in additional offsetting collections of about \$50 million over the 2007-2010 period. Hence, the net change in FHA subsidy costs over the period would be about \$75 million.

**GNMA Offsetting Collections.** GNMA is responsible for guaranteeing securities backed by pools of mortgages insured by the federal government. In exchange for a fee charged to lenders or issuers of the securities, GNMA guarantees the timely payments of scheduled principal and interest due on the pooled mortgages that back these securities. Because the value of the fees collected are estimated to exceed the cost of loan defaults in each year, the GNMA MBS program is estimated to have a subsidy rate of -0.21 percent in 2007, resulting in the net collection of receipts to the federal government.

Because most FHA-insured loans are eventually included in GNMA's MBS program, CBO estimates that implementing the zero down-payment program would result in additional collections to GNMA. We estimate that about 60 percent of the loan guarantees made under this new program would represent new loan guarantees for FHA that would not otherwise participate in GNMA's MBS program, resulting in the collection of \$2 million in 2007 and \$8 million over the 2007-2010 period. GNMA collections associated with the remaining 40 percent of the loans made under the pilot program are not included in this savings estimate because CBO estimates these borrowers would use the existing FHA program if the zero down-payment option were not available.

## **GAO Studies**

This legislation also would require the Government Accountability Office to prepare a report on loan performance under the zero down-payment program no later than two years following enactment of the bill and annually thereafter. CBO estimates that GAO would require less than \$500,000 annually beginning in 2008 for such reports. In addition, GAO would be required to study the financial soundness of the Mutual Mortgage Insurance Fund in the event that authority for the pilot program is expanded to more than 50,000 mortgages or extended beyond its sunset date of September 30, 2010. Because CBO cannot predict whether the pilot program will be expanded or extended, we do not estimate any costs associated with this study.

## **INTERGOVERNMENTAL AND PRIVATE-SECTOR IMPACT**

H.R. 3043 contains no intergovernmental or private-sector mandates as defined in UMRA and would impose no costs on state, local, or tribal governments.

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